Private Wealth Advisory

A Phoenix Capital Research Publication July 14, 2011

The Big Breakdown Has Begun Pt 1

If you'll recall, the primary question in my mind over the last two issues was whether the market dislocations we were witnessing were simply the start of a regular correction or another Crisis.

The market is slowly telling us that it is likely the latter. Indeed, the REAL Crisis, which I've been warning about since 2009 looks to be about to begin.

As a brief recap, the 2008 Crisis occurred when private US banks became so distrustful of one another's balance sheet risk that interbank liquidity dried up triggering a systemic implosion in the unregulated derivatives market, particularly in Credit Default Swaps (which was a $50-60 trillion market at the time).

The Federal Reserve dealt with this situation by suspending accounting policies (permitting banks to lie about their true balance sheet risk), offering to backstop those banks with the greatest derivative exposure (JP Morgan, Bank of America, Goldman Sachs, and Citigroup), shifting trillions of dollars' worth of toxic debt to the US balance sheet and then funneling trillions of new dollars into the banks most at risk of a derivative collapse (the banks I listed before).

In simple terms, the Fed attempted to paper over the problems of insolvency that were plaguing the large financial institutions. This scheme *could have* worked if the Fed had demanded that the large banks decrease their leverage, cease making the deals that created these problems and began regulating the derivatives market.

Short-Term Trends

-Debt contagion spreading to Italy
-Dead cat bounce in Euro
-QE 2 over
-MAJOR risk of deflation spreading from Europe
-Commodities and stocks at risk of severe correction (Gold and Silver stronger)
-US Dollar rally

Intermediate Trends

-The Fed/ Central Banks will attempt to step in with more liquidity later in 2011.
-China hard landing
-End of European Union
-Second severe global economic contraction underway (2008 only worse)

Long-Term Trends

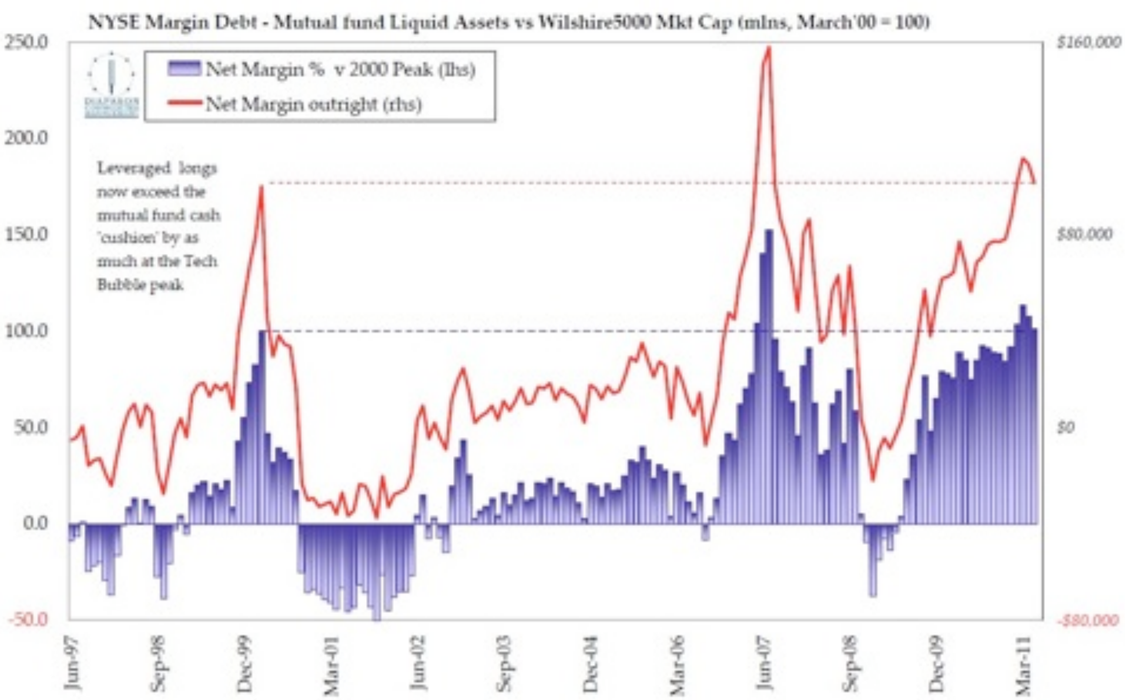
-Higher interest rates
- Widespread debt defaults/ restructuring
-Gold to return to currency backing
- Major bull market in agriculture, farmland, and alternative energy

However, the Fed is run by spineless academics not financial professionals or real businesspeople. So the Fed did not implement any meaningful reform. All it did was temporarily slow the pace of systemic implosion and give Wall Street a "get out of jail free" pass.

From a philosophical perspective, the Fed removed the notion of "risk of failure" from Wall Street's collective mind. As anyone who's studied human behavior can tell you, without consequence for one's actions most people will take their bad behaviors to the limit (I am not saying that there is no such thing as a principled person or one who lives a moral life… but generally speaking, most people, especially those who work on Wall Street where every move in focused on making more money, will take things to the max).

As a result of this, Wall Street went back to doing what caused the Financial Crisis in the first place: increasing leverage, fleecing clients, and paying its employees' excessive salaries.

As a result of this, the financial system is once again overleveraged. As noted in last issue, leverage levels today exceed those that occurred during the 2008 Tech Bubble (the first peak of the red line in the chart below).



Meanwhile, the large banks continue to be insolvent due to their gargantuan derivative exposure:

Bank	Total Assets (in Billions)	Derivatives (in Billions)
JP Morgan	$1,723	$79,459
Citibank	$1,161	$54,122
Bank of America	$1,451	$52,504
Goldman Sachs	$84	$44,979
HSBC	$192	$3,699
Wells Fargo	$1,093	$3,583
Bank of NY Mellon	$200	$1,477
Morgan Stanley	$68	$1,211
State Street Bank	$166	$1,067
PNC Bank	$251	$335
Suntrust Bank	$164	$334
Northern Trust	$79	$243
Regions Bank	$127	$121
US Bank National	$305	$84
Fifth Third	$108	$83
Keybank National	$86	$68
TD Bank National	$175	$66
BranchBankings	$150	$59
Union Bank	$80	$47
RBS Citizens	$113	$41
Ally Bank	$72	$34
TD Bank USA	$11	$34
Deutsche Bank	$44	$26
Capital One	$128	$25
Harris National	$49	$25

Put another way, the financial system is primed for another 2008 episode. The very same issues that caused 2008 remain in place. Leverage is far too high. And the unregulated derivatives market remains a multi-hundred trillion dollar problem.

However, the next Crisis will not simply be another 2008. The reason for this is that by transferring trillions in toxic debt to the public balance sheet, the Federal Reserve has put the US's credit rating and debt situation in jeopardy.

To be clear, the US was already bankrupt due to unfunded liabilities (including Social Security and Medicare, the US has over $50 trillion in debt). But the Fed's actions truly brought things to a tipping point.

Consider that before the Financial Crisis the Fed's balance sheet consisted of $800 billion worth of Treasuries. Today, thanks to QE 1, QE lite, and QE 2, it's $2.8 trillion. To put that number into perspective, it's larger than the economies of France, the UK, and Brazil.

Remember, most if not ALL of this increase was the result of the Fed taking on DEBT (and toxic debt at that). With only $51 billion in capital, the Fed now has a leverage ratio of 54 to 1. To put this into perspective, Lehman Brothers was only leveraged at 30 to 1 when it went bust.

To say that the US Federal Reserve is now insolvent would be a gross understatement. The only reason anyone trusts the Fed today is:

1) Tradition (it's backstopped the system since 1913)
2) The Fed has a printing press which means it can create money out of thin air
3) Lack of alternatives (what other entity in the US has a printing press?)

And the only reason the US financial system and currency haven't already collapsed is because other countries are in even worse shape and on the verge of collapse themselves (see Europe, China and Japan… China is rapidly heading towards a subprime crisis of its own).

However, this relative appeal (the US, while bankrupt, is in better shape than other countries) does not mean the US will avoid taking its medicine. That medicine will consist of some kind of debt default/ restructuring and a collapse in the Federal Reserve banking system. Put another way, it will mean an end to our current monetary system.

This process will involve bank holidays, severe market dislocations and crashes, temporary food shortages and consequent civil unrest.

I am in the process of updating all of the Phoenix Investor Personal Protection Kit Reports (Protect Your Family, Protect Your Savings, and Protect Your Portfolio) to provide even more details on how to prepare for these issues. I'll have the updated versions published before Monday of next week. But for now, I want to provide some Big Picture perspectives on what this Crisis will look like.

We are NOT going to enter some kind of "Mad Max" apocalyptic scenario. Indeed, the US has experienced several situations that were in fact worse than what's coming (the Revolutionary War, Civil War, etc). Europe and other, older regions have been through these scenarios countless times. And yet, despite these rough patches, the world moved on and the human race continued to thrive.

In the case of the US, let us consider the Revolutionary War for instance. At that time the US was comprised of a loose band of 13 colonies. To say the US was a unified country at this time would be an absolute lie. The four primary regions of the New World (New England, the Appalachians/ West, the mid-Atlantic/Pennsylvania, and the South) were each only populated by very different groups of people with very different attitudes towards freedom, liberty, equality, and religion.

Put another way, the idea of "America" was virtually non-existent when the Revolutionary War began. The notion that the US united to defend its "rights" against Britain is completely false (many colonists refused to fight at all during this period while others Americans actively traded with/aligned themselves with the British).

To put things very simply, during the Revolutionary War, the US was barely even a unified country facing one of the largest, most powerful, well-organized military forces in the world.

As an added bonus, colonists were struggling to even survive as they attempted to adapt Old World farming techniques and crops to their new climate. There was also the ongoing conflict with the American Indians taking place (I don't mean to imply anything here… just stating that your average colonist was not on good terms with the natives).

By the way, if you're looking to have a better understand of what really happened during the US's history (not the garbage that is taught in the US education system), I highly recommend Walter McDougall's books Freedom Just Around the Corner and Throes of Democracy. I promise you will be floored by what you read.

However, to return to our discussion of the Revolutionary War era, my primary point is that despite all of these enormous obstacles, the US managed to move through this period in its history and become the most powerful nation in the world.

So when the system collapses this time around, it will be rough, but we will get through it and come out even stronger. Indeed, the US history as a whole has been a continuous process of collapse and renewal. The approaching Crisis will be another period like this.

The first wave is going to come from Europe where it is clear that the ECB has reached the End Game of monetary intervention. To whit: Greece was bailed out only 13 months ago, it has since requested an extension on those loans and is now receiving a SECOND bailout.

Greece, as a country, really has very little to do with Europe's economy (it's about $330 billion out of the EU's $16 trillion GDP). However, Greece *was* the first nation to be bailed out. And so it has set the trend for what's to come in Europe. And what's to come is the following: default, political shakedowns, and civil unrest.

Ultimately, the BIG players in the EU Crisis are Spain and Italy with GDPs of $1.46 trillion and $2.1 trillion respectively. There literally is NO WAY the ECB can bail these countries out. Which is why in Europe the End Game looms and Greece's bailouts will ultimately be irrelevant.

What I mean by this is that the ECB has played its hand with the small players (Greece) and is now facing problems it cannot possibly solve. There is only one outcome to this scenario and it is default and restructuring which will involve European banks taking a "haircut" AKA losing billions of Euros worth of money on toxic debt.

However, there is a MUCH bigger problem here and that problem is the same one that created the 2008 disaster: DERIVATIVES.

US commercial banks have over $200 trillion in derivatives outstanding on their balance sheets. However, worldwide, the derivatives market is over $600 TRILLION in size. And the financial system in Europe is as saturated, if not MORE saturated with toxic debt than the US financial system.

According to the *Bureau of International Settlements*, the total exposure worldwide to PIGS (Portugal, Ireland, Greece, and Spain) debt is over $2.5 TRILLION. Most of this is in the form of derivatives. And 70% of it is from foreign entities (banks and firms located *outside* of the country).

Let's take Greece for instance. Courtesy of derivatives, France has $92 billion in exposure to Greece debt. Germany is on the hook for $69 billion. Great Britain has $20 billion. And the US has $43 billion.

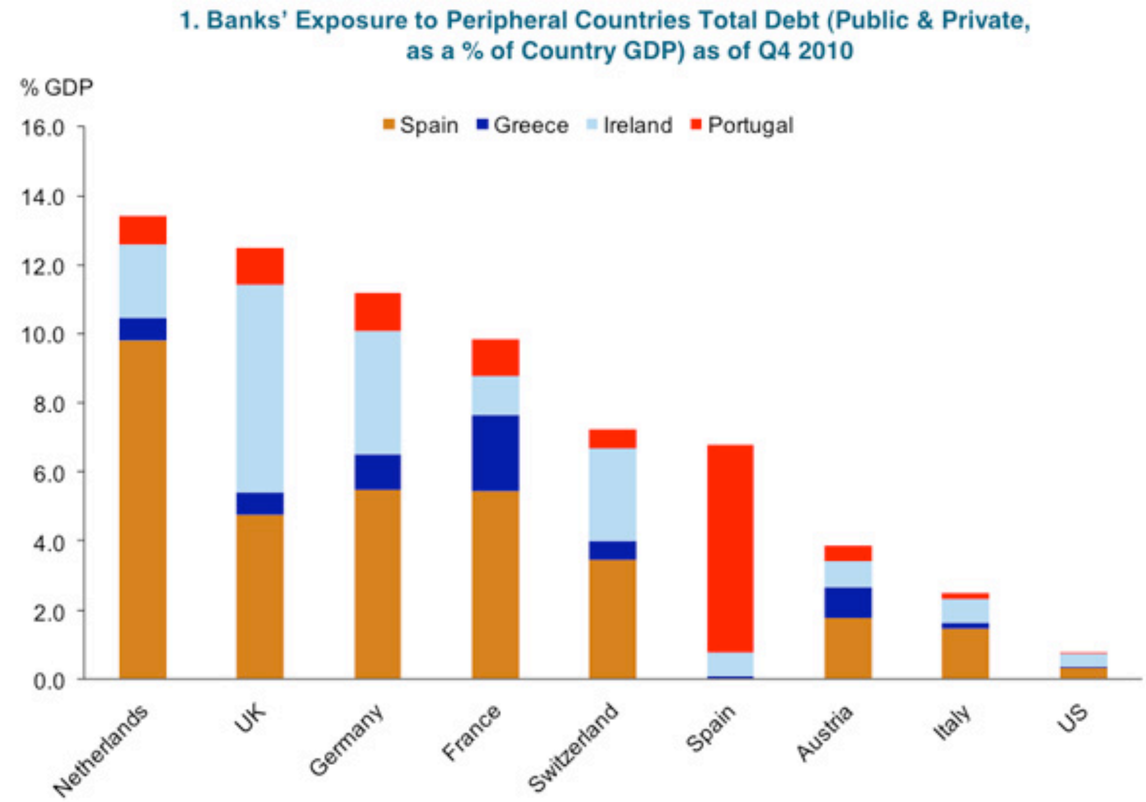
These levels, while dangerous, are not catastrophic. As I've stated before, Greece is NOT the big problem for the EU. However, worldwide exposure to Greek debt is in the ballpark of $277 billion. So a default there *would* result in significant market dislocations.

Now consider the exposure to a BIG Problem such as Spanish debt. In this situation, Great Britain is on the hook for $51 billion. The US is on the hook for $187 billion. France is on the hook for $224 billion. And Germany is on the hook for a whopping $244 billion.

As I said before, Greece is ultimately a small player in this mess. Worldwide exposure to Greek debt is $277 billion. **Worldwide exposure to Spain, on the other hand, is north of $1 TRILLION.**

Now this is where things get REALLY tricky. Because of the intertwined nature of the derivatives market, a Greek default could result in systemic risk for the simple fact that if one of the banks that goes down with Greece has extensive exposure to Spain as well, then things could get ugly very, VERY fast.

Indeed, as stated before, 70% of exposure to Portugal, Ireland, Greece, and Spanish debt is from foreign entities. The below chart from *BusinessInsider* does an excellent job of revealing just how big systemic risk is based on EU debt.



The above chart shows the bank exposure to peripheral countries debt as a percentage of GDP. For instance, UK bank exposure to Irish debt is roughly equal to a little over 6% of UK GDP, German exposure to Spanish debt is north of 5% of German GDP, etc.

To say that systemic risk is a MAJOR problem for the EU would be the understatement of the year. For instance, if Portugal defaults, Spain's banks will get taken to the cleaners. This in turn could trigger a HUGE systemic collapse as exposure to Spanish debt is equal to 4% or more of GDP for Switzerland, France, Germany, the UK, and the Netherlands.

And it's not as though the US is somehow free from this either. Altogether the US has $390 billion worth of exposure to PIGS (Portugal, Ireland, Greece, and Spain) debt. While not an enormous amount of money relative to US GDP (it's roughly 3% or so), we must remember that the US commercial banks have over $240 TRILLION in derivative exposure on their balance sheets.

And 82% of this ($200 trillion) is related to interest rates.

This is why Europe is BIG deal: a collapse in the bond markets there would push interest rates through the roof and result in various interest rate spreads (LIBOR, Treasury to Swiss Franc, etc) going haywire, which in turn could trigger another "Lehman" type event in the derivative market.

When this happens, those banks with the greatest derivative exposure relative to their underlying assets will all be at risk. I showed this chart before, but it's worth seeing again.

Bank	Total Assets (in Billions)	Derivatives (in Billions)
JP Morgan	$1,723	$79,459
Citibank	$1,161	$54,122
Bank of America	$1,451	$52,504
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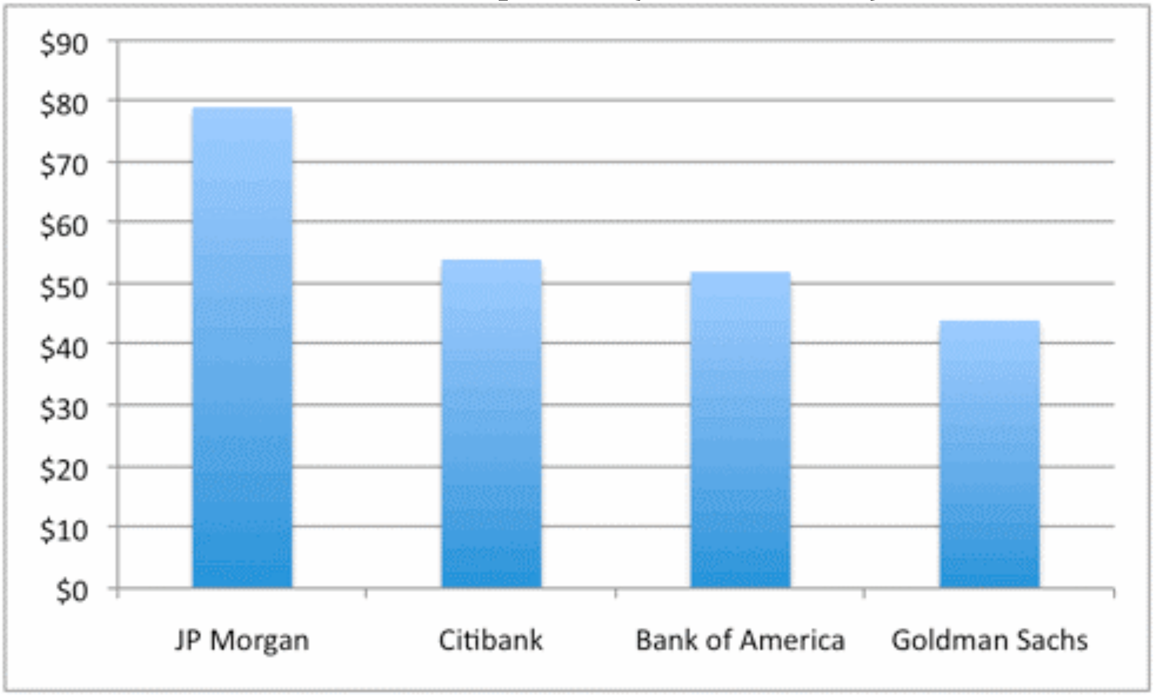
I would be very cautious about storing my savings or financial assets at these banks. When the derivative markets implode again (coming soon) none of these banks will be safe. And regarding derivative exposure, I would be *especially* wary of having any exposure (stocks, bonds, deposits, etc) to these four banks in particular:

Derivative Exposure (in TRILLIONS)



To put it mildly, the 2008 Crisis never actually ended. Instead, the toxic debts that nearly took down private banks have now spread onto sovereign balance sheets. And because the global financial system is so intertwined, even the default of a minor player in Europe (say Greece or Portugal) could bring about a systemic collapse at any time now.

For instance, let's say Portugal (which most countries have minimal exposure to) defaults. This would take down Spain which in turn would take down France, or Germany, or the UK or Germany. If any of these larger countries are hit, we'll see the Euro absolutely collapse which will result in a sharp US Dollar rally.

This in turn, could trigger an implosion in the interest-rate based derivatives market (over $200 trillion in size) which would result in a systemic collapse that would be at minimum four times worse than 2008.

This is why China has begun stepping in to buy up European sovereign bonds: because allowing a default in Europe will trigger a global systemic collapse that will destroy China's economy.

The EU accounts for roughly $400 billion of China's exports, making it China's single largest export market. So if Europe collapses, China's economy takes a BIG hit. Remember, China is a centrally controlled economy, NOT a dynamic open market economy.

Put another way, the entire China "economic miracle" is based on the current system continuing to operate in some form (China can continue to export, rip off intellectual property that is developed elsewhere, throw its weight around, etc).

But… if Europe collapses:

1) China loses its largest export market (Chinese economy breaks down)
2) China unemployment skyrockets along with civil unrest
3) The US Dollar rallies evaporating profit margins at Chinese export companies (Yuan is pegged to the US Dollar and so will strengthen) which results in even more unemployment
4) China's $700 billion or so in Euro-based assets implodes

With inflation erupting in the People's Republic and civil unrest growing, China NEEDS to keep its economy on track by whatever means possible, even if it means throwing money away to prop up bankrupt Europe.

Remember, China's unemployment numbers are based only on surveys in urban areas; they completely ignore the hundreds of millions of migrant workers who come to the cities to find work. I've seen some estimates of China's true unemployment rate that are north of 20%.

That's a heck of a big problem for China's totalitarian government to manage. This is why China is stepping in to prop up the European bond market. However, even this intervention will prove to be only a temporary support.

As you can see, the European currency just broke out of its triangle pattern last week in a big way. We've since seen a brief dead cat bounce at 140 which will be short-lived.

The 140 price level is of MAJOR importance for the Euro currency as it also marks the 200-DMA. As the below chart shows, the 200-DMA has been a critical level for long-term trends in the Euro for well over 5 years.

As you can see, every-time the Euro takes out this line, it plunges in a BIG WAY: the 2008 break below the 200-DMA resulted in an 18% drop while the 2009 break below the 200-DMA resulted in 21% drop.

We're about to break it again now. When we do the Euro is going to 135 then 120 in short order. And the long-term trendlines predict a break below the 2010 low of 118. Which is why once we take out 140 with conviction we'll be buying the **UltraShort Euro ETF (EUO).**

Regarding specific plays on the Eurozone collapse, I've been looking around for some European banks as potential short-selling candidates. However, the primary problem is that most European banks trade on US exchanges as American Depository Receipts (ADRs).

If you're unfamiliar with ADRs they're an investment scheme in which a large Wall Street bank (usually JP Morgan) buys actual shares in foreign companies and then packages them up into ADRs at a ratio of "real shares to ADRs."

So let's say JP Morgan owns 10,000 shares of XYZ Italian bank. It then packages these shares at a ratio of 10 shares to 1 ADR and then issues the ADRs on the pink sheet exchanges (the most illiquid exchanges in the US).

I realize this is getting quite technical. My primary point is that it is VERY difficult to invest in European bank stocks if you are based in the US. Those companies which you can invest in are extremely, and I mean EXTREMELY illiquid.

Take the Spanish Bank, **MAPFRE SA (MPFRF.PK)** a large Spanish bank that trades on the pink sheets. Despite having an $11 billion market cap, MAPFRE shares currently trade at only $3.70 per share. And the bank only trades an average of 5,100 shares per day.

Put another way, on a GOOD day only $15,000 worth of MAPFRE shares are traded. So obviously this investment is too illiquid for most investors. Which is why we're not touching it.

However, I've found one Spanish bank that is on the hook for hundreds of billions worth of credit risk to Spain and Portugal. It's more leveraged than Bank of America, has $1.2 trillion worth of credit risk and its entire shareholder equity base is only $103 billion.

I'm talking about **Banco Santander (STD).**

To give this company and its operations some context, I did a comparison of its finances against those of Bank of America, a bank that, to put it mildly, is insolvent and should be out of business.

	Santander	**Bank of America**
Total Assets	$1.6 trillion	$2.2 trillion
Shareholder Equity	$103 billion	$228 billion
Leverage	16 to 1	10 to 1
Deposits	$616 billion	$1 trillion
Deposits/ Net Assets	38%	45%

Right off the bat, STD is more leveraged than BAC, which says a lot. STD also has 51 billion Euros worth of Spanish and Portuguese debt on its books: an amount that is equal to HALF of the bank's ENTIRE shareholder equity.

When we dig deeper into STD's derivative structure and credit risk things get even uglier.

STD has 1.2 TRILLIONS Euros' worth of credit risk worldwide. Of this, it has 427 BILLION Euros in credit risk related to Spain and another 43 billion Euros in credit risk related to Portugal. **Put another way, STD has a total of 470 billion Euros worth of credit risk to bankrupt countries. This is FOUR TIMES STD's shareholder equity.**

On top of this, STD has 145 billion Euros worth of Level 2 and Level 3 assets. If you'll recall from 2008, these are the illiquid assets that Wall Street pretended were worth much more than they actually were… right up until they collapsed.

Given the fact that the Spanish housing market is as toxic as the US's, you better believe a sizable chunk of STD's Level 2 and Level 3 assets are toxic garbage just waiting to collapse.

Finally, STD also has $46 billion in over the counter derivative exposure. That's not a huge number, unless you consider that it's only got $6 billion worth of collateral on this position. So $46 billion in risk… on just $6 billion in capital. And of this risk, 62% is made to counterparties that have medium grade credit ratings… while **another 13% is made to counterparties that are BELOW investment grade.**

In simple terms, STD is a bank with MAJOR liquidity and solvency problems… all of which could wipe out its entire shareholder equity base in a flash. The chart is darn ugly too:

As you can see, STD has *just* broken out of a massive triangle pattern. If confirmed (meaning STD cannot reclaim the lower trendline), this pattern predicts a drop to $5 if not lower. However, I'd first wait until we take out $10 to go short here.

In simple terms, it's too early to go short here. But as soon as it's time to go short STD I'll send out a market update.

This concludes Part 1 of this issue. I'll published Part 2 which will feature three new inflation hedges and a full portfolio review tomorrow after the market closes. Until then…

Good Investing!

Graham Summers

OPEN POSITIONS

Inflation Portfolio (OPEN BUYS NOW)					
Company	**Symbol**	**Buy Date**	**Buy Price**	**Current Price**	**Gain/ Loss**
Gold bullion	N/A	3/17/10	$1,120	$1,583.00	41%
Silver bullion	N/A	3/17/10	$17.50	$38.28	119%
IamGold	IAG	5/25/11	$20.95	$20.94	0%
Centamin Mining	CEE.TO	5/25/11	$2.01	$2.02	0%

Deflation Portfolio (OPEN BUYS NOW)					
Company	**Symbol**	**Buy Date**	**Buy Price**	**Current Price**	**Gain/ Loss**
Dollar ETF	UUP	5/23/11	$21.79	$21.47	-1%
UltraShort Materials	SMN	5/23/11	$18.31	$17.05	-7%
UltraShort Brazil	BZQ	6/23/11	$17.05	$16.69	-2%
UltraShort Agric.	AGA	6/23/11	$18.88	$16.12	-15%

Watchlist (Waiting to Buy)	
Company	**Symbol**
UltraShort Russell 2000	TWM
UltraShort Emerging Mkts	EEV
UltraShort Euro	EUO
Banco Santander (Short)	STD